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Look Back—3rd Quarter 2012

I have noticed over the years the difficulty some people have in cutting losses, admitting an error, and moving on. I am rather frequently – and on occasion, quite spectacularly – wrong. However, if we expect to be wrong, then there should be no ego tied up in admitting the error, honoring the stop loss, selling the loser – and preserving your capital. – Barry L. Ritholtz (CEO Fusion IQ, *Bailout Nation*, The Big Picture blog, 8/12/2010, b. 1961)

Barry L. Ritholtz is one of the few strategists who foresaw the coming of the housing implosion and derivative mess far in advance of the actual crash. Ritholtz issued warnings about the market collapse and recession in time for his clients and readers to seek safe harbor. In 2010, Barry L. Ritholtz was named one of the "*15 Most Important Economic Journalists*" in the United States. Ritholtz writes a column on Investing for The Washington Post; he also contributes occasional columns to Barron's and Bloomberg. In his daily work, Mr. Ritholtz is CEO and Director of Equity Research at Fusion IQ, an online quantitative research firm. His firm provides institutional research to individual traders and investors.

I think Mr. Ritholtz teaches us an important lesson about investing. The lesson is that we should not let our ego get in the way of good decision making because no strategy works all the time – especially in investing. According to a research report I read a few years back, the most successful investors are only right about 50-60% of the time. The secret of success is to cut losses before they become too deep and look for a better opportunity. When markets are doing reasonably well as they have since 2009, investors get lulled to sleep (forgetting what happened in 2008) and are content with inaction. The heavy infusion of money into the financial system by the Federal Reserve over the last few years has kept stock prices artificially propped up and investors happy. However, this last round of stimulus seems to be about as much as the Fed can do. It is now up to the politicians in Washington to break political gridlock and address unemployment as well as the "fiscal cliff" (the end of the Bush era tax cuts on December 31, 2012). Stock prices will eventually have to stand "on their own two feet." It is still my opinion that no matter who gets elected, we will experience difficult stock markets over the next 2-3 years because the economy is advancing at such a slow pace.

That being said, the third quarter 2012 was very good. The Dow was up +4.28%, the S&P 500 up +5.66% and the NASDAQ also up +6.1%(Source: Stock Trader's Almanac). The NASDAQ has already given back -3.55% of that gain in October as of this writing but it was still a very good quarter if we look at its own merit.

It should come as no surprise that most mutual funds also did very well during the third quarter. The average diversified U.S. stock mutual fund returned +5.3% in the three months ending in September. Diversified International stock funds averaged +6.8% and Emerging Market funds returned an average of +6.9%. Most bond funds followed the stock uptrend by turning in strong performances as well. Intermediate Investment-Grade bond funds returned an average of +2.5% with High-Yield bond funds averaging +4.3% in the quarter. (Source: Wall Street Journal 10-3-12).

I think I would be remiss if I did not try to add some perspective to the second and third quarter 2012 performance as well as the 2012 year-to-date results which have been very good. As Paul Harvey would always say, "And now the rest of the story..." Looking at the big picture, the all-time closing high for the DOW in 2007 was 14,164.53. It ended the third quarter 2012 at 13,437.13. The closing high for the S&P 500 in 2007 was 1565.15. It ended the third quarter 2012 at 1440.67. If you were only in the market for the last three years a "wow" might be in order but if you were in the market for a longer period of time like most of us, the reality is the market has not even reached its prior high levels after five years. So the next time you hear how well a manager has done in the last three years, be sure to ask how they have performed since the high in 2007 and especially how they did with the losses of 2008 averaged in. In many cases, there have been very modest gains, if any, in personal portfolios.

As mentioned in my September article, I will be focusing on Social Security analysis as a complement to the Money Management Program. There is much more to Social Security strategy than simply deciding to take benefits at ages 62, 66 or 70. I will continue to write about this topic on a regular basis in the newsletters. This month's guest article on Long Term Care is by Nyal Bischoff. Nyal is **not** a member of the networking group that I have mentioned in previous newsletters; however, he has an extensive background and experience in Long Term Care. Over the past 12 years I have guided many clients in this area but have come to realize that I can no longer keep up with the many changes that have been occurring. My focus will continue to be on active Money Management and Social Security analysis. Since Nyal specializes in Long Term Care, he will work with me and provide expertise in that area when needed.

Enjoy the fall weather and take good care!!!

Stay the Course!!

By: Nyal Bischoff

If you have been reading any financial news in the last several months you no doubt have become aware of the turmoil in the long term care industry. Major carriers have exited the market and rate increases are commonplace. What's behind all of this turmoil which is unnecessarily causing would be customers to put off the proper decision to protect their life savings?

The culprit is the confluence of three distinctly different yet very important items that has the industry in a straight jacket. The 1st of these is that claims ratios have been somewhat higher than initially anticipated thus causing higher than expected losses. Second, lapse rates are radically lower than what was projected. And finally, the artificially suppressed interest rate environment that we have been in for the past 3 years has insurers handcuffed in their efforts to reserve for future claims and stay profitable. (Current interest rates rival the rates during the Eisenhower administration in the 50's.)

Here is another way to look at this. Suppose yours is a typical 2 income household with a growing family and all the usual financial obligations such as a car and mortgage payment and college funding etc. One of you loses your job. A predictable income stream has evaporated. Here comes belt tightening 101. Fixed expenses won't stop but all other spending is under the carving knife. You have some savings but you don't want to rely on that too heavily and you are hoping you can find another job soon. This would be a prudent course of action in light of the circumstances because it's sink or swim.

Let's draw some parallels for the insurer: Similarly, the predictable income from lapsed policies has evaporated. You will be laid off until 2015. Ben Bernanke has publically stated that we will see these low rates at least to 2015. The meager unemployment benefits that you can draw are the equivalent of practically no return on the insurer's investments for the next 3 years. Bound by state laws that govern their investments, insurers can't invest in bonds in Greece and Spain where the yields are much higher. Unlike your ability to limit discretionary spending, insurers have an on-going stream of new incoming claims, thus no way to limit those ever increasing costs. The only solution is to raise premiums for old and new policies, streamline operations and product discounts or to exit the market. Some insurers have simply made a business decision to exit market. (Don't worry if you have a policy from one of those insurers because the company is still plenty solvent and will pay your claim should it occur.) Thus the insurance companies are doing the same thing you would do if you lost your job. "THIS TOO SHALL PASS."

Here is what gets lost in all this uncertainty. YOUR HEALTH. You think it makes sense to ride out this storm and postpone the decision to protect your assets. As time goes on those few extra pounds we all put on now catch up with us and after the lab results come back with your latest physical your doctor issues a prescription for both cholesterol and high blood pressure medication. You just lost a preferred health discount of as much as 10% for the life of your policy. And if the readings come back suspicious on a PSA test or mammogram you could be temporarily uninsurable and unable to even apply for coverage. A birthday occurs during the year or more waiting period to become eligible again thus causing the rate to go even higher.

So the message here is much like life after 9/11. We got through it. The world is different today for insurers offering long term care protection. Through this turmoil, NO ONE is getting younger and rarely do we get healthier. We can only hope to maintain the good health that we enjoy now and as my doctor says "We are all healthy until the day we are not". As we all inevitably "age in place" we gradually move toward the day when we may possibly need help just getting through the day like our parents or grandparents. That risk is very real. It is very important not to disassociate the probability of that risk with the emotional and financial impact that risk would have on your loved ones. That is the worst possible time for crisis management. So plan ahead and be prepared for any eventuality and give you and your family choices and the peace of mind of protection.

Since 1988 Nyal Bischoff has specialized exclusively in long term care insurance helping thousands of people in Michigan protect their life savings from the high cost of care. As an independent agent he represents all the top carriers in both the traditional and hybrid long term care markets and is skilled at helping people navigate this complex area critical to a complete financial plan. You need facts to make an informed decision. Explore your options. Nyal can be reached at 248-828-8304 or nyal@comcast.net.